Client Alert.

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U.S. Supreme Court Invites Solicitor General's Views on Whether to Grant Review of Case Implicating Key Pleading Standard for Securities Claims

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Yesterday, the Supreme Court invited the U.S. Solicitor General to express its views on whether the Court should grant plaintiffs' *certiorari* petition in *The Laborers District Counsel Construction Industry Pension Fund v. Omnicare, Inc.*, No. 09-1400 — a case that should be of interest to securities issuers, underwriters, accountants, and others who potentially face the threat of lawsuits under Section 11 of the Securities Act of 1933.

Granting *certiorari* in *Omnicare* would provide the Court an opportunity to consider a long-contested issue of securities pleading: whether Section 11 claims that "sound in fraud" must be pleaded with particularity in accordance with Rule 9(b), or whether they need only satisfy the more lenient notice pleading standards of Rule 8(a).

THE PLEADING ISSUE

Federal Rule of Civil Procedure 9(b) requires a complaint to "state with particularity the circumstances constituting fraud." Courts recognize that Rule 9(b) plays the important role of protecting a defendant's reputation from empty charges of fraud by preventing plaintiffs from proceeding with a fraud claim unless the complaint alleges adequate factual support. Rule 9(b)'s requirements also give defendants fair notice of the alleged fraud and protect them against strike suits. Securities fraud claims under Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 must satisfy Rule 9(b)'s heightened pleading requirements — as well as the pleading standards of the Private Securities Litigation Reform Act. Accordingly, Rule 9(b) requires securities fraud plaintiffs to allege (at the very least) what is false about a challenged statement and why it is false.

Section 11, however, does not require proof of fraud: it provides a cause of action for investors who acquire registered securities issued under a "materially false" registration statement, even if the misstatement was not made with fraudulent intent. Because fraud is not an element of a § 11 claim, courts generally evaluate such claims under Rule 8(a), which requires only "a short and plain statement of the claim." Where, however, a § 11 claim is premised on allegations of fraud — that is, where it "sounds in fraud" — the law of nearly every Circuit requires the underlying facts to be alleged in accordance with Rule 9(b). Among other things, this rule serves one of the "primary purposes of Rule 9(b)" by "protecting defendants from the reputational harm that results from frivolous allegations of fraudulent conduct," even where those allegations are made in support of a § 11 claim. After all, as one court reasoned, it would do little to preserve a defendant's reputation if Rule 9(b) did not govern an allegation that: "The defendant is a no good defrauder, but, even if he is not, the plaintiff can still recover based on the simple untruth of the otherwise fraudulent statement." Only the Eighth Circuit arguably has declined to apply Rule 9(b) to § 11 claims that sound in fraud.

Rule 9(b) has proven to be a valuable tool for § 11 defendants facing allegations that they engaged in fraudulent conduct, especially where the same alleged wrongdoing serves as the basis for claims under § 10(b) and § 11. The role of Rule 9(b) is particularly important for those routinely involved with registered securities offerings — such as accountants and underwriters — who face the prospect of repeat § 11 claims and whose reputations are particularly threatened by frivolous allegations of fraud.

THE *OMNICARE* CASE

In *Omnicare*, plaintiffs asserted securities fraud claims against Omnicare, Inc., a provider of pharmaceutical care services to residents of long-term care facilities. Plaintiffs alleged that Omnicare engaged in a “fraudulent scheme” to inflate its stock price by misrepresenting the company’s financial results and business practices. Among other things, plaintiffs alleged that Omnicare violated Generally Accepted Accounting Principles (“GAAP”) by improperly recognizing revenue, overvaluing receivables and inventory, and failing to take proper reserves for litigation expenses and other contingent liabilities. These alleged accounting errors served as a basis for plaintiffs’ claim that Omnicare committed securities fraud in violation of § 10(b) and Rule 10b-5. Plaintiffs alleged that these very same GAAP violations also supported liability under § 11 because Omnicare’s financial statements were incorporated into the registration statement for its $761-million public offering in December 2005.

The district court was not impressed with plaintiffs’ claims: it dismissed the complaint, finding that plaintiffs had merely “attempted to ‘reverse engineer’ a securities fraud action based on bad corporate news.” The court held that the alleged GAAP violations could not support plaintiffs’ fraud claims because the complaint did not allege “loss causation,” a required element for § 10(b) liability. Plaintiffs failed to allege loss causation because they identified no public disclosure that Omnicare’s financial statements were false, and no resulting drop in Omnicare’s stock price. In fact, the court noted that Omnicare never restated the challenged financial statements and that Omnicare’s independent auditors continued to certify the accuracy of Omnicare’s financial statements. In a footnote, the court also dismissed plaintiffs’ GAAP-based § 11 claim for failure to plead loss causation, noting that the claim “sound[ed] in fraud.”

On appeal, the Sixth Circuit voiced similar skepticism of the complaint in affirming dismissal of plaintiffs’ § 10(b) fraud claims, observing that plaintiffs merely had tried “to turn bad corporate news into a securities class action.” The Sixth Circuit, however, reversed the district court’s dismissal of the § 11 claim. Although the court agreed that the complaint did “not suggest that the alleged GAAP violations were ever recognized by or revealed to the market,” and therefore failed to plead loss causation, it noted that loss causation “is not an element of a § 11 claim, but an affirmative defense.” Accordingly, the Sixth Circuit remanded the § 11 claim to the district court. In so doing, the Sixth Circuit instructed the district court to evaluate the claim under Rule 9(b), because the alleged GAAP violations “sounded in fraud.”

THE *CERTIORARI* PETITION AND THE “CVSG”

On May 14, 2010, the *Omnicare* plaintiffs filed a petition for a writ of *certiorari*, asking the Supreme Court to review the Sixth Circuit’s determination that the § 11 claim had to satisfy Rule 9(b) because it sounded in fraud. The petition asks the Court to consider three questions: (1) whether claims under § 11, which requires no proof of fraud, are subject to Rule 9(b); (2) whether investors seeking relief under § 11 may be required to plead facts showing either fraud or negligence; and (3) whether courts may require plaintiffs to plead facts rebutting the § 11 affirmative defense of due diligence.

As Omnicare noted its in brief opposing plaintiffs' *certiorari* petition, this is not the first time that the Supreme Court has been given the opportunity to consider the application of Rule 9(b) to § 11; the Court has declined numerous *certiorari* petitions raising this issue, including in 1996, 2003, and two in 2008. Perhaps signaling a continued interest in pleading standards on the heels of its decision in *Ashcroft v. Iqbal* (2009), however, the Court did not deny review in *Omnicare* out of hand. Instead, it issued an "Invitation" to the Solicitor General ("SG") to file a brief on whether the Court should grant review. When issued such an Invitation, also known as a "CVSG" because it ***C***alls for the ***V***iews of the ***S***olicitor ***G***eneral, the SG always files a brief in response with a recommendation as to whether the Court should grant review.

The Supreme Court issues such Invitations only a dozen or so times each year. The Court does so in cases where it wants to be informed by the expertise of the United States even though the federal government is not a party. Generally, Invitations are issued where the federal government has a significant interest in the underlying federal law because of related federal programs or enforcement efforts. In this case, for example, as the SG formulates its position, it likely will solicit the views of the Securities and Exchange Commission, as well as those of other interested U.S. government agencies. The Court's Invitation indicates the Court's interest in hearing whether the United States thinks that *Omnicare* presents an important enough question of securities law to warrant review.

An Invitation by the Supreme Court to the SG cannot be read as a determination that the Court ultimately will grant review. More often than not, the SG recommends that the Court deny the petition, and the Court usually follows that recommendation. But an Invitation does indicate that the odds of *certiorari* being granted in the case are significantly higher than for a typical *certiorari* petition. It takes four Justices to issue an Invitation, just as it takes four Justices to grant a *certiorari* petition. The Court grants *certiorari* in only about 4% of petitions on the Court's "paid" docket, which consists of petitions where the filing fee is paid and excludes those petitions filed by a prisoner or other indigent individual. For paid petitions on which the Court issues an Invitation for the SG's views, the percentage jumps to approximately 33%.

The Supreme Court's practice does not impose a specific deadline by when an Invitation brief must be filed. The SG usually takes at least 60 to 90 days to file an Invitation brief and sometimes takes significantly longer than that. Once the SG files the Invitation brief in *Omnicare*, the parties all will have an opportunity to file a supplemental brief before the Court decides whether to take the case. Assuming that the SG files its Invitation in 90 days, and that the Court grants *certiorari*, the briefing on the merits likely will take place next spring, with oral argument to follow.

BOTTOM LINE

Courts recognize that Rule 9(b) provides important protection against strike suits and "safeguards a defendant's reputation from improvident charges of wrongdoing." As the Second Circuit has noted, these considerations "apply with equal force to 'averments of fraud' set forth in aid of Section 11" claims. Given the key role of Rule 9(b) in protecting the reputations of defendants, and the nearly universal current practice of applying Rule 9(b) to § 11 claims that sound in fraud, the *Omnicare* case bears watching. Even given the heightened notice pleading scrutiny introduced by *Iqbal* and *Bell Atlantic Corp. v. Twombly* (2007), if the Court were eventually to hold that Rule 9(b) is inapplicable to all § 11 claims, it is quite possible that many § 11 claims that today are dismissed (at least in the first instance) for failure to comply with Rule 9(b) could, in the future, survive pleading challenges.

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